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Statement of James R. Young
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Submitted to the Surface Transportation Board
on the Staggers Rail Act of 1980

My name is Jim Young. I am President and Chief Operating Officer of Union Pacific Railroad Company. I appreciate the opportunity to present to the Surface Transportation Board Union Pacific's views concerning the Staggers Rail Act of 1980 on its 25th anniversary.

Introduction

This hearing comes at an historic turning point for the freight rail industry. After decades of reducing capacity, railroads now have an opportunity to grow.

Thanks to the Staggers Act, America's railroads have made progress toward providing a private freight rail network that is safe, efficient, and financially viable and contributes to the economic vitality of our nation. But that work is not complete, and important challenges lie ahead.

For the first time since World War II, the industry faces significant capacity constraints, with demand exceeding supply. Government transportation officials and experts say that railroads are not yet investing at a rate that will meet future transportation needs. This growing rail infrastructure shortfall is part of a broader shortage of transportation capacity in the United States that government is not able to prevent.

When I meet with customers, almost all of them ask the same question: "Will the railroads be able to meet our needs in the future?" All of us—railroads, public officials, and rail customers—will play pivotal roles in answering that question.

As we review the Staggers Act and look to its future, we must ensure that public policies, including the framework of economic regulation, support railroad expansion to meet the ever-growing demands of the customers and communities we serve. The question this Board must consider, the question every customer representative must consider, is "How big a national railroad system should America have?" To put that question differently, we must ask how severely government regulation will constrain growth and how much traffic will be unable to ride on the railroads as a result.

This hearing provides an important forum in which to discuss the ability of the railroads, and our partners in the private and public sectors, to support growth. My testimony will review the success of the Staggers Act in meeting the challenges of the industry to date. I also will review the capacity challenges that face the industry and how those challenges should be met.

The Success of the Staggers Act

As some remember, the freight rail industry was on the verge of collapse before passage of the Staggers Act. Main lines suffered standing derailments, and many railroads went bankrupt. The Interstate Commerce Commission would not allow railroads to earn normal returns on investment or set competitive rates. During the 1970s, Union Pacific Corporation separated its non-rail assets from Union Pacific Railroad because of the risk that the entire rail industry might be nationalized. At the time, Union Pacific was probably the nation's healthiest railroad, but excessive government regulation made the future look bleak.

The Staggers Act, and its revitalization of the industry, was among the most successful stories of deregulation. Staggers stripped away harmful regulation and allowed the industry to respond to the marketplace in many ways. It provided the industry with the ability to price most of its services based on demand. As a result, the industry achieved quantum leaps in productivity, reduced prices as it consumed excess rail capacity, and gained the chance to earn adequate revenues. Rail safety, particularly for chemical shipments, improved sharply.

The railroad industry became far more important to the economy than anyone could have foreseen in 1980, when the industry's future was in question. With the productivity increases that the Staggers Act spawned, America's privately-funded highways of steel became the envy of other nations. They haul more freight and serve more customers than ever before. They are environmentally friendly, safer than highways, and reduce congestion on the nation's roads. At Union Pacific, we have set all-time traffic records in recent months. There is no question that customers, consumers, and the nation as a whole benefit from the cost-effectiveness and improved financial posture of the industry, made possible by the Staggers Act.

The New World of Constrained Rail Capacity

The freight rail sector is stronger today as a result of the Staggers Act, but this is no time to start poisoning the patient again with renewed regulation. Twice during the Twentieth Century, economic regulation drove the railroad industry to the brink of ruin. Twice the nation's taxpayers had to bail out the railroads. All of us must remember those lessons from history. The stakes today are very high.

We must build upon the successes of the Staggers Act and ensure that the industry can serve the country's transportation needs, even as demands on the transportation system continue to grow. Public policy must address the primary transportation challenge of the decade, and probably of the 21st Century: the need for greater infrastructure investment to address an ever-increasing transportation capacity shortfall.

Economic forecasts indicate continuing growth in demand for rail infrastructure. According to the experts, though, railroad investment is not yet adequate to meet the challenge.

Every stakeholder in rail transportation should understand the study performed a few years ago by the American Association of State Highway and Transportation Officials (AASHTO). More recent federal transportation studies reach the same conclusion: freight traffic growth over the next 20 years will continue to outstrip transportation supply, and the shortfall will continue to worsen. Although economic fluctuations will occur, the AASHTO Report predicts that the rail capital expenditures will, through 2020, fall $52 billion short of the amounts needed to keep up with the growth in <u>existing</u> rail traffic. That means that, at recent investment levels, the railroads would not be able to draw traffic off the roads to alleviate the nation's highway crunch. Moreover, the organic growth of <u>current</u> rail traffic would not be accommodated on the rail system. So, unless investments increase significantly, the industry will not be able to meet growing shipping needs, and some types of traffic will have to leave the rail system as demand outstrips supply.

Bolstering the worrisome predictions of the AASHTO Report, the entire transportation network is stressed and falling further behind traffic levels. The trucking industry faces continuing driver shortages and record fuel costs. The highway system is congested, and everyone recognizes that the recently passed highway bill does not provide for the additional funding that will be needed to handle traffic growth down the road. Shippers will continue to look to the railroad industry as an alternative. We want to be there, to the maximum extent possible, to meet their future transportation needs.

The Substantial Investment Needs of the Rail Industry

The rail industry is already capacity constrained. Union Pacific handled record carloads in 2004, and we anticipate an increase in carloads during 2005, setting yet another record. Continued strong demand for rail services is pushing the limits of our capacity and stressing our system.

At Union Pacific, we believe that our railroad hit the capacity limit first. Our densities per track mile were as high as any, and most of our lines carry a wide mix of traffic that consumes more capacity than a uniform traffic base.

In response to these challenges, Union Pacific has implemented the initial phase of its Unified Plan. The plan focuses on operational improvements that increase velocity, reduce terminal dwell, improve asset utilization, and enhance network capacity. Operations are also being refined using industrial engineering techniques, especially at yards and terminals. But these operational improvements will not be sufficient to meet ever-growing transportation needs. Union Pacific also must make significant investments in rail corridors and terminals.

Union Pacific faces capacity constraints in several of its key corridors. As we told the Board in our fall peak letter, demand already outstrips our capacity on the Sunset Route between El Paso, Texas, and Los Angeles, where we are steadily adding second main track. We also have limited capacity on our South Central route between Los Angeles and Salt Lake City, which serves as an overflow option for the Sunset Route. On our Central Corridor, the original transcontinental railroad, we are pushing the limits of capacity in Wyoming, in eastern Nebraska, and across Iowa. Our lines between Kansas City and St. Louis, primary coal routes, will need additional capacity. We are looking at additional investments in southeast Texas, especially near Houston, as well. Although we already are investing in several of these corridors, additional investments in track and signals will be needed to serve the continually growing needs of our customers.

We also will need to reinvest in major terminals to ensure that they can handle traffic growth. Our infrastructure in key terminals such as Phoenix, Los Angeles, Houston, San Antonio, and Chicago will require upgrading and expansion. In addition, Union Pacific must invest in intermodal and transloading terminals to keep up with significant intermodal growth. These investments will allow us to better serve our customers in the near term, but even more investments will be needed long-term to keep up with projected needs of our shippers.

New capital investments are costly, and the capital needed to operate a railroad is substantial. A new mile of main track can cost up to $2.25 million. We own all of the equipment needed to install and maintain that track. When there is a natural disaster, such as the two hurricanes, or our recent washouts in Kansas, or the storm that hit the West Coast earlier this year, we repair our privately owned tracks. Between 1996 and 2005, Union Pacific devoted $23 billion to capital investments.

At Union Pacific, we are ramping up investment. In 2005, Union Pacific will spend an all-time record of $2.8 billion, including $700 million in cars and locomotives, $300 million in additional capacity, and $219 million in new commercial facilities. We also are hiring at record rates. Our customers, however, want to put even more traffic on the railroad than these investments will allow.

The Transportation Capacity Challenge

The railroad industry's ability to invest is limited by its ability to earn sufficient returns. Investment analysts continue to note that railroads have not reached sustained revenue adequacy and cannot yet justify much higher levels of investment in new capacity. Debt ratings depend upon a company's ability to consistently generate the cash needed to repay debt obligations. Investors will provide capital only if they are confident of sufficient returns on their investments.

Every time I meet with our Board of Directors, they remind me of the direct nexus between returns and capital investment. Our Board will authorize us to expand our railroad, but only if they believe that investment will produce adequate returns. If Union Pacific can improve its returns, we will have the ability to increase our capital investments and grow the railroad's ability to handle freight. Without adequate returns on invested capital, however, our ability to grow, and our ability to take on our customers' growth, will be severely limited, as AASHTO predicts.

Ultimately, there are only two sources of funds that will justify expanded capacity. One is the taxpayer. I see no indication that the government, which is already underfunding the highway system, will fund huge capacity growth on the railroad system, even though the AASHTO Report says that doing so would be the nation's smartest investment in transportation capacity. The second source of funds for reinvestment is the revenue generated by the community of customers who use the rail system.

Union Pacific also has a responsibility, of course. We must continue to improve our operational efficiency, pursue public/private partnerships that can protect the freight network, and seek a level playing field from Congress.

We understand that our customers find themselves in a situation today that differs from what they previously experienced. Until recently, the rail industry had excess capacity, as track supply exceeded demand. The Staggers Act allowed the industry to fill or shed its excess capacity to improve its financial health. Customers enjoyed a buyer's market, in which railroads offered lower and lower rates to fill up capacity. These rates, however, did not justify reinvestment in the rail system, and we were in a slow liquidation, as evidenced by abandonment programs and line sales. Investment analysts who follow the rail industry termed this a "going-out-of-business" strategy that could not continue.

Now we are in a world in which excess capacity has been consumed and demand exceeds supply, with no long-term reversal of this phenomenon in sight. To keep up with demand, more revenues—and higher returns—will be needed to finance the investments necessary to address growth. Increasing most rates to reinvestment levels will be critical.

Regulators and policymakers have important responsibilities in connection with the capacity challenges of the future. Government economic regulation directly affects railroad returns. As a result, it will directly affect the extent of investment by the railroad industry and directly influence or constrain the size of the future rail system. More regulated rates and lower returns will mean restricting the size of the national rail system of the future. As I said earlier, the question before the Board, as it evaluates the Staggers Act 25 years later, is how big a national rail system does America want? How much of the growing demand for rail transportation will the rail system be allowed to accommodate?

Regulation and decisions applying regulation will determine how much transportation infrastructure can be funded by the private sector. Any government action that reduces rail revenues will reduce future investment levels. Any effort to curtail rail revenues in one market will send errant signals to the marketplace, redirecting capacity investment resources away from where they are needed and where the market would put them to other, more attractive options. Regulation and policies that investors view as undermining adequate rates of return will reduce or limit the investments that investors are willing to make. That, in turn, will erode the industry's ability to provide the greatest transportation benefit for the most customers, the very reason why the Staggers Act was passed in the first place.

At Union Pacific, we understand that customers want the lowest possible rates. We also understand that our customers are frustrated when the service they receive does not appear to be worth its cost. We are dedicated to improving the reliability of our service and earning the rates we charge. At the same time, short-term thinking that results in driving rail rates downward would cripple the industry's ability to meet future demand. The new world of constrained capacity requires a continuing dialogue between railroads and their customers to ensure that today's decisions do not undermine tomorrow's opportunities for all of us.

In a world of constrained capacity, regulation also needs to encourage, not prevent, the efficient use of scarce transportation capacity. Regulation that protects inefficient use of capacity will reduce the availability of transportation. For example, with excess capacity, a railroad can stop a train on its main line for 90 minutes to serve a low-volume shipper without reducing the line's capacity and depriving other customers of rail service. When a railroad is operating near its capacity limits, however, blocking that track for 90 minutes may reduce the line's total capacity by three trains per day—trains that could serve hundreds of customers. The nation cannot afford regulatory policies that protect inefficient use of scarce capacity, whether by carriers or by customers.

By working together to enhance the use of capacity, railroads and their customers can greatly improve service and expand transportation capacity. Last year, for example, Union Pacific took controversial action during a period of congestion. We reduced the number of cars in our south Texas aggregate service. At the same time, though, we worked hard with customers to load longer trains, load and unload trains on weekends, and improve customer facilities.

These cooperative actions resulted in substantially increased loadings, better use of capacity, and improved service.

The ultimate challenge for the future is to ensure that the railroads grow with transportation demand. If we allow railroads to achieve and sustain adequate revenues and earn their cost of capital—enabling them to attract and retain needed capital and justify reinvestment—then rail capacity can continue to grow in an effort to meet growing transportation need. If regulators and policymakers curtail needed revenues, then the industry will not be able to reinvest in existing capacity and will invest in less new capacity. The industry will inevitably be smaller than it could be, and fewer transportation needs will be met in the future.

Customers want us to be there for them. If we cannot invest sufficiently, we will not be able to meet their transportation challenges in the future. We will not be able to be there for them. It is just that simple.

Conclusion

The national interest requires a viable freight rail network in the private sector that can provide efficient and cost-effective transportation service responsive to the needs of customers. The Staggers Act was instrumental in moving us toward that goal, and it is still instrumental today. It provides a policy framework that, if applied properly, allows a private rail system to survive and compete.

Now we must ensure that the progress made in the post-Staggers era continues, and that the law's objective of providing service responsive to the marketplace is pursued in the new world of capacity constraints. Unprecedented levels of investment will be required, but without sufficient returns, the capital will not be available. It is thus imperative that government take no actions that frustrate the efforts of the freight rail industry to expand with their customers. If the necessary capital is not available, then our rail transportation system will fall far short of the needs of a vibrant economy—an outcome that is clearly not in anyone's interest.